SHADES OF GRAY

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"Sometimes you will fail and be blamed for things you had absolutely nothing to do with."

—Former Governor Gray Davis
Keynote speech to Columbia University
Law School graduation, May 21, 2009[1]

Gray Davis, the 37th governor of California, took office in 1999 in a period of prosperity. Unlike his two predecessors, Pete Wilson and George Deukmejian, both of which became governor in periods of budget crisis, Davis—thanks to what would eventually be known as the dot-com boom—was initially blessed with state revenue. By the time he ran for re-election in 2002, he was dealing with a major fiscal problem that eventually led to his recall a year later. His successor, Arnold Schwarzenegger, promised to fix the state's budget problems and without a tax increase. Yet Schwarzenegger found himself mired in another budget crisis during his second term. Given that later history, in hindsight can Davis be blamed for the fiscal problems that led to his recall?

Not surprisingly, there is not a clear-cut answer to that question. But it can be said that the style of Governor Davis' leadership left him vulnerable to crisis. It can be said that despite the prosperous times in which he was initially elected, the state's proneness to budget crises was apparent. And, it can be said that his successor was naïve about the difficulty of changing the institutional structure of the budget process.

DIFFERENT PERSONALITIES

"I have prepared my whole life for this moment."

—Governor-Elect Gray Davis
Shortly before taking office[2]

Davis and Schwarzenegger were very different in background and personality. Davis, a Democrat, was a lawyer by training and was a career politician.[3] He served as chief of staff to Governor Jerry Brown and subsequently became a state assemblyman, controller, and then lieutenant governor. In the 1998 Democratic primary, Davis ran against two wealthy and self-financed candidates, seemingly as the dark horse in the race. Yet his two rivals managed to defeat each other and Davis emerged as the winner in the primary. Davis based his campaign on his political experience and promised that his focus, if elected governor, would be on education. In the November general election, he easily defeated his Republican opponent, Attorney-General Don Lungren.

Arnold Schwarzenegger ran in the 2003 recall as an outsider—not a politician—who would clean up state politics. Although it was his movie career that made him a high-profile candidate, he emphasized his business background which would allow him to rid the state of governmental waste and inefficiencies. Because he was wealthy, Schwarzenegger argued, he would not have to depend on special interests.

Schwarzenegger was most successful in terms of public approval when he displayed optimism and humor—and least successful when he seemed combative. In contrast, Davis retained the image of a somewhat stand-offish career politico. Despite these sharp differences in public personas, Governor Schwarzenegger ended up facing a budget crisis at least as severe as the one that defeated Davis in the recall. After a series of ballot propositions related to the budget were rejected by voters in a May 2009 special election, words such as "Armageddon" and images of California driving off a cliff were regularly used.

UP AND DOWN: A BUDGET SUMMARY OF THE DAVIS YEARS

"Their job is to implement my vision. That is their job."
—Governor Gray Davis
discussing the role of the legislature[4]

Table 1 provides data on budget proposals made during Governor Davis' period in office. Except for proposals made in 2003, the proposals are the initial ones made in early January for the coming fiscal year beginning the following July 1. For 2003, the table shows both the January and the "May revise" proposal; the May revise of 2003 was the last proposal made by Governor Davis because of the recall in October of that year.

Proposals are not the same as the adopted budget ultimately passed by the legislature. But they do show the intentions of the governor. Yet they can be misleading. The table indicates that Governor Davis repeatedly—until the very end—submitted budgets that were expected to deplete the General Fund reserve. (We avoid the words deficit and surplus to describe these changes in the reserve because budget proposals are not confined on the receipt side to revenue but rather also include "transfers" from outside the general fund, including borrowing.) However, Governor Davis was not necessarily being profligate.

During the dot-com boom, revenue kept rising faster than forecast, even relative to what was projected half way through the ongoing fiscal year. (Table 1 shows that projection as well as the proposal for the next fiscal year.) In the late 1990s, revenue from capital gains related to stock market and employee stock option capital gains poured into the state treasury. Although spending was being ramped up, in effect the legislature could not keep up with the inflow.

Table 1: General Fund Budget Proposals By Governor Gray Davis ($ Billions)

	January 1999		January 2000	
	Estimate for 1998-99	Proposal for 1990-00	Estimate for 1999-00	Proposal for 2000-01
Revenue & Transfers	$56.3	$60.3	$65.2	$68.2
Expenditures	58.3	60.5	65.9	68.8
Change in Reserve	-2.0	-0.2	-0.7	-0.6
End of FY Reserve	+1.1	+0.9	+3.0	+2.4

	January 2001		January 2002	
	Estimate for 2000-01	Proposal for 2001-02	Estimate for 2001-02	Proposal for 2002-03
Revenue & Transfers	$76.9	$79.4	$70.9*	$79.3
Expenditures	79.7	82.9	78.4	78.8
Change in Reserve	-2.8	-3.4	-7.5	+0.5
End of FY Reserve	+6.6	+3.1	+1.5	+2.0

*The Davis administration treated a loan for electricity purchases in 2000-01 repaid by rate-payers in 2001-02 inconsistently. It was treated as part of revenue and transfers in the January 2002 estimate for 2001-02 but not included as an expenditure in prior presentations. This treatment has been corrected in the table above.

	January 2003		May 2003	
	Estimate for 2002-03	Proposal for 2003-04	Estimate for 2002-03	Proposal for 2003-04
Revenue & Transfers	$72.2	$73.1	$70.8	$70.9
Expenditures	76.8	75.5	78.1	70.4
Change in Reserve**	-4.5	-2.3	-7.3	+0.5
End of FY Reserve**	-2.1	-4.5	-9.3	-8.8
End of FY Reserve with Proposed Borrowing***	na	na	+1.4	+1.9

**Excludes proceeds from proposed borrowing of $10.7 billion proposed for 2002-03.

***Includes proceeds from proposed borrowing of $10.7 billion proposed for 2002-03.

na = not applicable.

Note: Details need not sum to totals due to rounding. Source: California Legislative Analyst's Office.

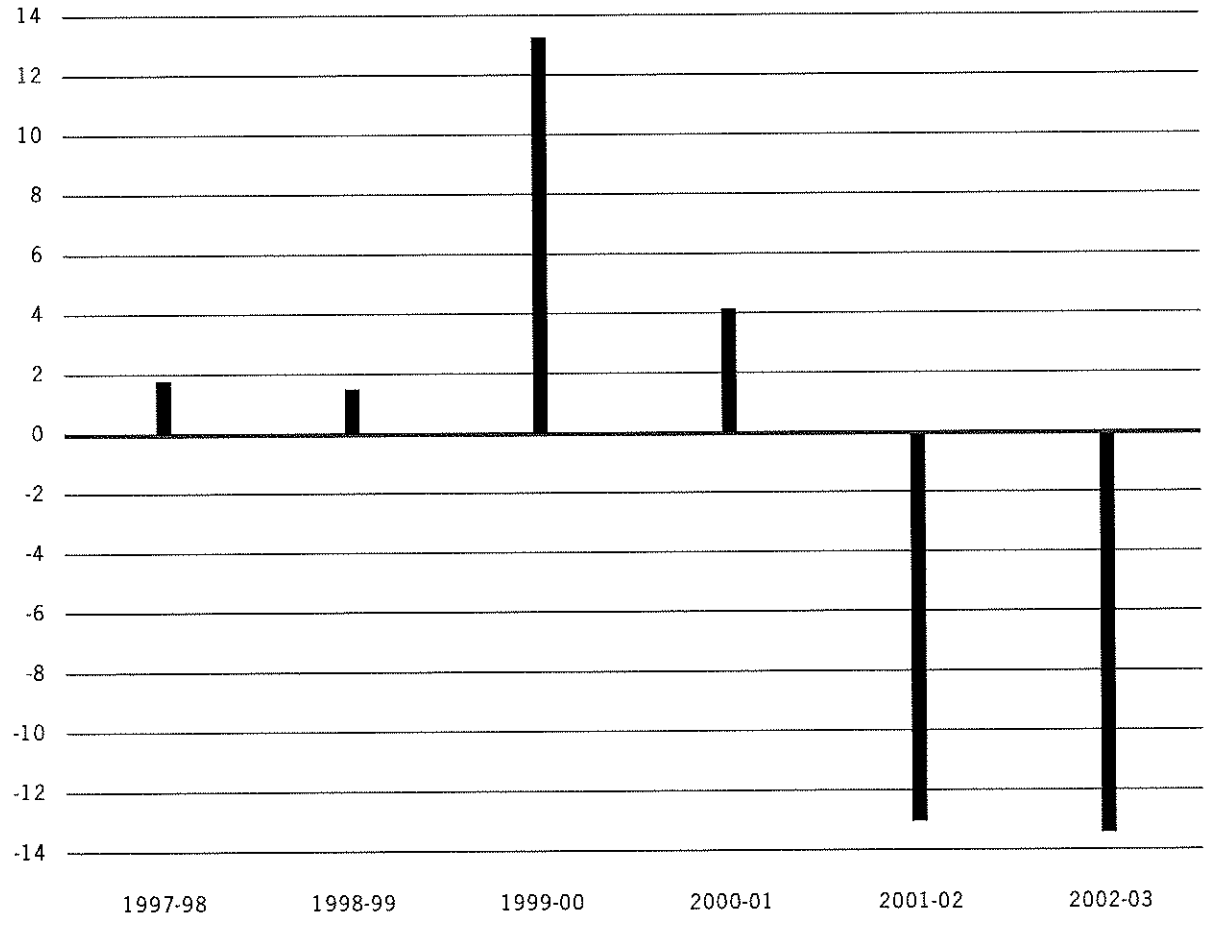
And during the upswing, Davis may well have counted on positive budget "surprises" to develop after his preliminary January proposals.

Chart 1 shows the end-of-fiscal-year reserve as a percent of expenditures for that year. Note that at the peak, the reserve was roughly one eighth of general fund spending, a "rainy-day fund" target that Governor Schwarzenegger later tried to mandate via a ballot proposition in May 2009, but failed. The chart also shows how fast even such a large reserve can be dissipated.

In a little more than a year, the reserve went from roughly one-eighth positive to one-eighth negative! Toward the end of the period shown, the state was dependent on short-term borrowing to finance its deficiency in the general fund. Governor Davis then proposed refinancing California's debt through a legally-questionable long-term borrowing scheme which his successor essentially adopted and legalized via two ballot propositions in 2004.

It is not surprising that a governor's popularity would be enhanced by a good economy and generous budgets and that the reverse would occur in Hard Times. However, as will be described below, during the good years the leadership style of Governor Davis and his cool relationship with legislators in both parties brought him few allies. When the recall threatened, in large part because of the budget crisis that had developed, he had few friends to which he could turn.

Chart 1: End-of-Year General Fund Reserve as Percent of Annual Disbursements



TAKING OFFICE

"Too many families of every ethnicity have thrown up their hands in frustration, concluding they have no choice but to send their kids to private or parochial school. I say enough is enough. The time has come to restore California's public schools to greatness!"

—Governor Gray Davis
1999 inaugural address[5]

The threat of an eventual budgetary debacle that would lead to his 2003 recall was not part of Governor Davis' thinking when he took office. As in all bubbles, there was much rationalizing in the financial press as to why the stock market—especially the dot-coms—could go on rising at a rapid pace indefinitely. The fact that many dot-com startups seemed unable to turn a profit was a matter of discussion, but was often dismissed as a sign that the new technology was in the early stages of maturing. Profits justifying the current stock prices would surely appear in the future.

In 1999, a book entitled *Dow 36,000* appeared, encapsulating this mania.[6] The book's argument ran that the business cycle was disappearing. Stocks generally were not as risky as was once the case and therefore were undervalued, according to its authors' analysis. Once stocks came to be perceived as essentially riskless by the market, the Dow-Jones Industrial Average could rise to 36,000.

Davis' 1999 inaugural address focused heavily on improving education, his major campaign theme. But he also pledged to end "wedge issue politics," a slam at his predecessor, Pete Wilson, who was in attendance at the ceremony and who had won re-election in 1994 in part on the issue of illegal immigration. Thus, Davis—from the start—exhibited a combativeness that impeded his relations with the legislature and even his own top administrative officials. Later in the year, for example, there was a high-profile spat between Davis and Lieutenant Governor Cruz Bustamante about how to deal with the lawsuit —left by Wilson—defending Proposition 187. Prop 187 attempted to deny state services to illegals and was largely struck down through litigation.[7]

It also soon became apparent that Davis had a strong tendency toward micro-management and against delegation, even delegation to top appointees. This tendency was initially explained by his press secretary as simply matter of administrative start-up. "It's important that the people he appoints understand where he wants to go," the aide said.[8] But in fact the tendency persisted throughout the Davis era, leading to paralysis of decision making and to a lack of support for the governor when the recall challenge developed.

In the early years, however, Davis' micro-managing style was something to joke about. "We have a simple policy," he said. "I'm the only one elected in this administration."[9] But even then, Davis' need for micro-managing showed up in the form of unfilled vacancies in many state positions. "The governor has spent a tremendous amount of time on the appointment process," an aide explained.[10] That was precisely the problem.

THE FIRST BUDGET: 1999-00

"I am disappointed that I do not have more resources to allocate to programs that I want, but I have to bring this budget into balance."

—Governor Gray Davis
announcing his first budget[11]

When it came to his budget proposals for 1999-00 unveiled a few days after the inauguration, education was again the centerpiece with proposals ranging from pre-school programs to higher education. A general theme would be that there would be more money for

education but on the other hand there would also be more accountability for student outcomes. Davis suggested that parents should sign formal contracts with schools to enhance their children's academic advancement. Shortly after the budget announcement, the governor was photographed reading *"The Little Engine That Could"* to elementary school students, a symbolic scene that later was repeated for national television.[12]

Overall, however, the new budget was based on revenue projections that were conservative. Senate Republican leader Ross Johnson noted that the stock market was bringing in capital gains and termed Davis' projections as "pessimistic."[13] Groups that might have expected more generous results from a Democrat expressed disappointment over the tightfisted proposals.

Public-sector unions noted that the budget contained allowances for only modest pay gains. Teachers' union spokespersons were cautious about the governor's proposals for tests and performance reviews. Local officials complained that revenues allocated for their level of government were inadequate. However, budget director Tim Gage said the governor "didn't want to be overly optimistic and miss the mark on the high side."[14]

In effect, Davis was positioning himself as fiscally prudent. Since the actual budget would not be adopted before the May revise, any positive revenue surprises could then be incorporated. Positive surprises began to accumulate as soon as February when Legislative Analyst Elizabeth Hill pointed to good economic news and projected further revenue increases as a result. By March, larger-than-budgeted pay raises for state employees were negotiated by the Davis administration. Apart from direct pay increases, Davis shored up his relationship with organized labor—private sector as well as public—by agreeing both to improved state labor standards and to upgraded labor standards enforcement. But he also tilted conservative through such gestures as refusing paroles to convicted murderers.

Despite Davis' centrist balancing, Republicans in the legislature preferred tax reductions to his new programs. On the tax day April 15th, they called for various tax cuts, including eliminating the Vehicle License Fee ("car tax"), a property tax on cars collected by the state for local governments. The state would then compensate local governments for the resulting losses in revenue. Under former Governor Wilson, a staged reduction of the car tax had already been set in place, but not total abolition.

THE MAY 1999 REVISE

By the time of the 1999 May revise, revenue projections had been raised by $4 billion since the January budget proposal. Governor Davis now proposed various infrastructure project— something that business interests supported—although in the past many such projects were financed by earmarked taxes and trust funds rather than the general fund. More money would go to schools—including bonuses for teachers —and there would be bigger pay raises in the revised plan for state workers.

Some tax cuts were included but these would be delayed beyond the budget year. That proposal became a sticking point for Republicans. GOP assembly leader Scott Baugh said his members "will not accept that there is no place for taxpayers at this bountiful table."[15] Assemblyman Tom McClintock threatened that an initiative would be put on the ballot to abolish the car tax, a tax he characterized as "outmoded and mean-spirited."[16] McClintock's partner in this endeavor would be People's Advocate, the group that was eventually to sponsor the 2003 recall. The notion of a bountiful table was reinforced shortly after the

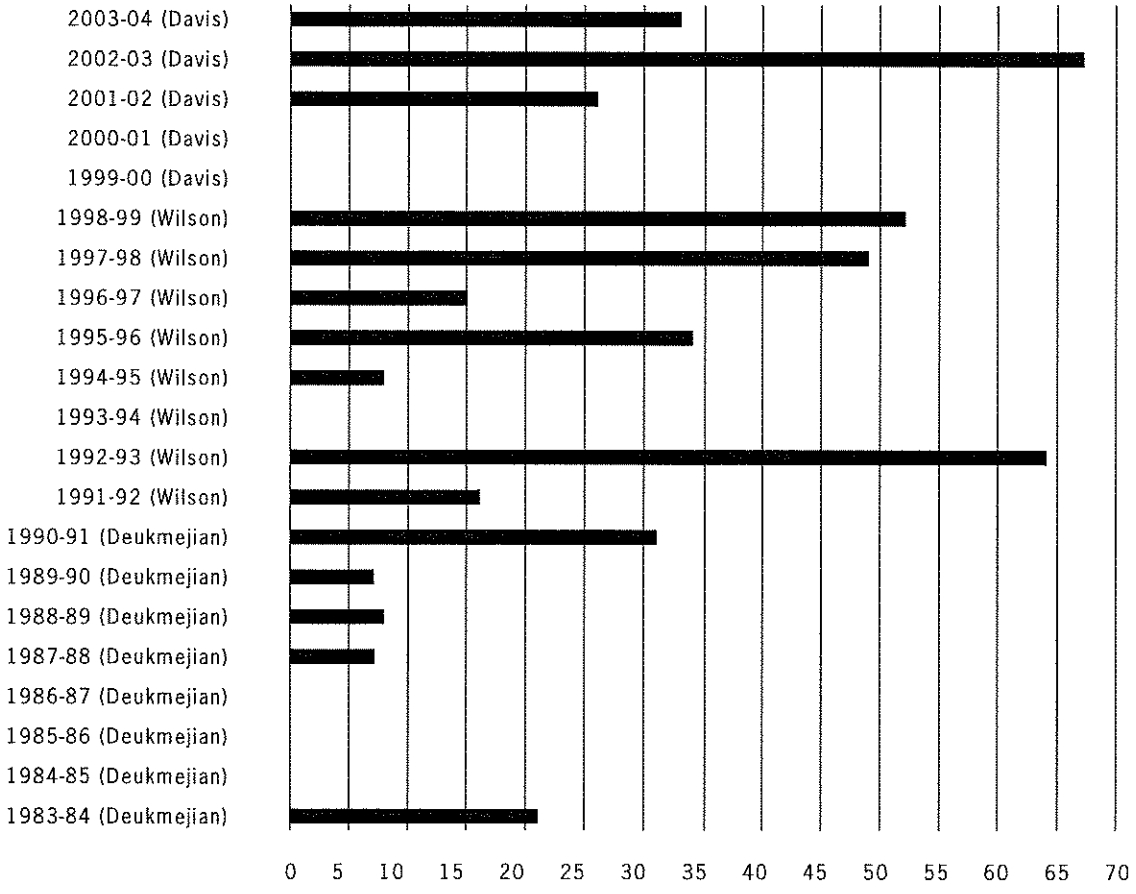
May revise when the Legislative Analyst projected still more revenue than Davis had assumed in his revision.

Governor Davis was anxious to bring in a budget deal on time—in principle even by June 15, the date the legislature is supposed to be finished with it. Such a timely enactment would be seen as a change from the notable delays that had characterized the Wilson era. As Chart 2 shows, Pete Wilson had only one on-time budget; his predecesso—George Deukmejian—had experienced only two major delays, both in times of budget crisis. With the threat of a car tax initiative and with pressure from legislative Republicans in mind, Davis agreed to a reduction in the car tax. That cut was later to figure in the 2003 recall when he temporarily reversed it.

A DEAL IS REACHED

The legislature did not quite meet the June 15 deadline but seemed close to reaching a deal with Republicans, a few of whose votes were needed to reach the required constitutional two-thirds supermajority. Essentially, Republicans bargained for further tax cuts at the margin, such as adding truckers to the car tax cut, and for a credit for research and development for business. The budget was enacted on June 16, one day after the official deadline but well before the start of the new fiscal year on July 1. However, it took until June 30 for the governor to sign off on the budget and announce various line-item vetoes totaling over a half

Chart 2: Days of Budget Delay Beyond June 30 Until Signing



billion dollars, a sign of the detail-orientation that characterized Governor Davis.

As part of the accord, Davis had the legislature cut out the chairing role of the Lieutenant Governor—who had feuded with him over the Prop 187 litigation—in a new commission to deal with the upcoming 2000 federal Census. The governor's vetoes included various "pork" projects in Republican districts which GOP legislators insisted they had been promised as part of the budget negotiations. Davis spokesperson denied the governor had gone back on his word.

Davis himself said that he couldn't let Republicans keep all the pork they wanted while cutting pet projects desired by legislative Democrats. But the controversy created a climate of mistrust. Republican senator Jim Brulte noted that "we work here on a system of good faith and trust" and that that Republican leaders believed that Davis "did not keep his word."[17]

It was not only Republicans who expressed concerns about the governor. Various education bills supported by Davis were before the legislature. The Davis administration put pressure on balking Democratic legislators in ways they considered inappropriate. After the governor was quoted as saying it was the job of the legislature to implement his vision, some legislative Democrats made their unhappiness semi-public. Senate president John Burton simply said he had "a different point of view on the matter."[18] Meanwhile, another gubernatorial feud with Democratic state controller Kathleen Connell was also being reported.

While times were good, however, such conflicts were largely the concerns of state political junkies, not the general public. Davis was able to cultivate his image as a tough-minded centrist with a bent for improving education and fighting crime. And by the fall of 1999, it was apparent that revenues were again exceeding projections.

Calendar 1999 came to a close with various groups pushing for ways to spend the funds that the stock market kept adding. Republicans wanted more tax cuts. The California Teachers Association (CTA) threatened to sponsor a ballot initiative to earmark more money for schools unless it was delivered legislatively in the next budget. Infrastructure improvements, accelerating the opening of UC-Merced, student fee reductions in public universities, all were being on the table for potential funding.

YEAR TWO: PROSPERITY

"California is flush."

—Governor Gray Davis
presenting his budget for 2000-01[19]

As the new calendar year opened, much of the pre-budget debate revolved around education funding. CTA wanted per-pupil spending raised to the national average. But the Davis administration resisted anything that costly. One advisor to the governor argued that voters were not interested in abstract numerical goals. "We polled it and focus-grouped it during the campaign... It's simply not where people are," the advisor noted.[20] Davis preferred particular targeted education programs such as special rewards for good teachers, increased teacher training in state higher-education institutions, rewards for college grads to go into teaching, and such.

Competing with possible spending on education was a court decision voiding a fee on out-of-state cars brought into California, mainly by newcomers to the state, ostensibly for their "smog impact." The fee had been imposed in the Wilson budget crisis of the early 1990s and would now have to be refunded to those who had paid it. Governor Davis also had spending objectives related to social welfare programs. The goals

included pay raises for state-paid home care aides and expansion of health insurance for children of the working poor. Davis also supported a ballot measure scheduled for March 2000 that would reduce the popular vote required for school bonds to be approved from two thirds to 55 percent.

THE JANUARY PROPOSAL

When the budget proposal was unveiled in early January 2000, public discussion continued with educational interests pressing to increase per-pupil spending. Republicans were pushing for more tax cuts than the governor had suggested and asking for more funding to be returned to local governments. In two respects, Davis seemed to be returning to his early apprenticeship as chief of staff to former Governor Jerry Brown. Brown accumulated a large reserve in the general fund—often viewed as a factor in the passage of Proposition 13 which drastically cut property taxes in 1978. Angry property taxpayers saw their tax bills rising at the local level while the state enjoyed a large and growing reserve.

Davis also wanted to add funding to the reserve. He was aware that relative to the 1970s, the state had become more dependent on the stock market to generate capital gains tax revenue. Any reversal in the market could undermine state finance. Perhaps sensitive to Davis' concerns, Assembly speaker Antonio Villaraigosa proposed a ballot initiative that would halt scheduled cuts in the Vehicle License Fee (car tax), with the money to go for education.

Jerry Brown was also famous for his disdain of the large-scale public works projects that had characterized the era of his father, Governor Pat Brown. In 2000, Davis was criticized for failing to address transportation and congestion adequately. While Davis supported the idea of cutting the hurdle for voter approval of school bonds to 55 percent, he did not endorse a related proposal that would allow voter approval of transportation taxes by only 55 percent. The governor did eventually support the idea of limited use of general fund revenue for transportation projects and a bond measure for transportation to be put to voters.

Yet it was hard to adhere to a posture of fiscal restraint in the face of continuous positive budget surprises. Only a few days after Davis formally presented his January proposal for 2000-01, Legislative Analyst Elizabeth Hill projected that revenues would in fact be $3 billion higher than he had forecast. The chair of the Senate's Republican caucus Jim Brulte (who was soon to become minority leader) commented that "we can do everything Governor Davis wants, as well as what we'd like to do."[21] Since Republican votes would be needed to pass a budget even in prosperous times, it would be hard to say "no" to their agenda when there was money around for so much else.

Apart from the governor, there was recognition—at least in some quarters—that a budget based heavily on the rapidly-advancing stock market could suffer a sharp reversal if the capital gains went away. But it was tough to keep from partying in the face of the substantial revenue inflows. State School Superintendent Delaine Eastin—a Democrat but like others in a tenuous relationship with the governor—in particular pushed for more educational spending than Davis had proposed.[22] During the spring, the spat over education funding continued. There was debate over how many dollars would be required to bring state per-pupil spending to the national average. And CTA continued gathering signatures for its ballot initiative to force such spending.

GANN AGAIN?

One possible check on the growing demands for state spending was the long-irrelevant Gann Limit. In the aftermath of Prop 13, voters passed Prop 4 (dubbed the son of Prop 13), which capped state spending according to a formula. The Gann Limit quickly became irrelevant due to the recession in the early 1980s that brought down spending well below the limit.

Gann resurfaced briefly in the form of a required tax rebate during Governor George Deukmejian's second term in the late 1980s when the limit was hit. But that episode triggered Prop 98 of 1988 which earmarked funding for K-14 via two formulas and partly gutted Gann. The gutting was completed two years later by another initiative—Prop 111—that also added an additional formula to Prop 98. A final blow was the recession of the early 1990s, which—as had the recession of a decade before—brought down state spending. However, with the recovery in the late 1990s and the stock-market related revenue surge, it appeared that even gutted Gann might become a constraint.

With hindsight, it appears that the Gann limit was ultimately exceeded although no one knew at the time and no explicit Gann-mandated tax rebate ever resulted. Nonetheless, the revival of Gann did have the effect of putting a constraint on the eventually-enacted 2000-01 budget. The constraint arose particularly because Davis—shortly before the May revise—acceded to additional education funding. He made a deal with CTA in which the union's proposed ballot initiative was dropped.

With more educational spending, there was less room for the many other proposals and demands that were surfacing. The May revise combined the deal with an income tax rebate which was not technically linked to Gann. A final cherry on the budget sundae was a proposed exemption of school teachers from the income tax.

FROM MAY REVISE TO FINAL DEAL

The notion of a total income tax exemption for teachers did not find a warm reception in the legislature, partly because of concerns that other professions might also demand similar treatment. CTA was not keen on the exemption idea, fearing it would stir voter resentment against teachers. Other ideas were floated such as a limited tax credit or a cut in teacher pension contributions. How a more general income tax rebate would be handled was also a sticking point.

It was argued that an income tax rebate would be partly diverted to the federal government since state income taxes are deductible from income declared on the federal income tax. Democrats pushed for an alternative sales tax rebate of some type. Republicans wanted a guarantee that future scheduled cuts in the Vehicle License Fee (car tax) would not be impeded by other elements in the budget. The wrangling over tax cuts and rebates led to delays beyond the official June 15 deadline for the legislature to enact a budget.

With Republicans focused on the car tax, eventually the tax rebate plan was scrapped and an increased cut in the car tax was substituted. The reduction in the car tax previously scheduled for 2004 was shifted into the 2000-01 budget. In a move to make the car tax cut visible, motorists would receive rebate checks back in the mail for part of the tax they paid. (This cumbersome process was later abandoned after several months of rebates by an equivalent straight-forward rate reduction.) With that issue settled, the legislature passed the budget and it was signed with ceremony —after vetoes totaling $1 billion by the governor— on June 30. The vetoes kept the total budget, i.e., general fund plus special funds, just below $100 billion. Several budget-related bills were signed later including various teacher incentives.

WARNING LIGHT

In 1996, an elaborate electricity plan for California was adopted with bipartisan support in the legislature as well as support by Governor Wilson. The theory was that competition in electricity supply could bring down the costs of power. Generation (power supply) would be separated from distribution. Customers, both residential and commercial, would buy from the cheapest source. Retail prices would be controlled and capped until the former generating/distribution regulated monopoly firms divested themselves of their generation capacity. Despite the appealing theory, there are many practical issues in any deregulation scheme, once the plan moves from general concept to specific details.

Unlike other markets, electricity demand and supply must match exactly, moment by moment. Insufficient supply can cause equipment failures at both the supply and demand ends. So there must always be enough power, something that can only be ensured either by having excess capacity or by quickly cutting off power (blackouts) to some customers. The electricity market can be subject to manipulation unless the deregulation plan includes a new version of regulation to prevent artificial withholding of power and ensure sufficient supply and capacity. As it turned out, California's deregulation plan was flawed and was famously manipulated on the supply side.

Governor Davis was not responsible for the original deregulation plan, since it was signed into law by his predecessor. However, Davis' tendency to micro-manage and his aversion to delegation meant that his administration could overload in a crisis situation. San Diego Gas and Electric was the first major utility to divest itself of its generating capacity and so was free to raise its rates. San Diegans saw their electric bills soar in July 2000, leading to a public outcry. That outcry should have been a warning sign that there were problems with the larger deregulation scheme outside of San Diego.

The solution developed for San Diego ratepayers was a short-term transitional patch whereby rates would rise more gradually through a borrowing arrangement. It did not include a re-evaluation of the entire deregulation plan to see if other problems lay ahead. Various issues competed for Davis' attention in summer 2000 such as creating a César Chavez holiday for the state and deciding how the state would celebrate the 150th anniversary of statehood. There were pressures to enlarge the Cal Grant funds for college tuition and controversy over a possible state law to resolve labor disputes for police and firefighters through an arbitration process.

Also competing for the governor's attention was the aftermath of a scandal that had led to resignation of Insurance Commissioner Charles Quackenbush, a bill related to racial profiling by police, reduction of fees at state parks, political jockeying surrounding various ballot measures destined for the November election, and nursing home regulation. One of these measures would be the ballot proposition that would reduce the voter approval hurdle for school bonds from two thirds to 55 percent.[23] In short, it was easy for the warning light flashed in San Diego on electricity deregulation to be ignored, especially if all important and not-so-important decisions ended up in the governor's office.

And there was so much good news to announce, including a reduction in the sales tax beginning on January 1, 2001, triggered by the state's revenue boom and extra payments to schools for education of the disabled, a matter that had been in litigation for years. The projections for 2001-02 also were rosy, according to the legislative analyst and the Department of Finance. "Extra revenue in the billions," was how the forecast as of November 2000 was characterized by the Department of Finance spokesperson.[24]

However, there also were suggestions that maybe some of the revenue should be spent to shore up the

electricity deregulation scheme which had already caused the San Diego uproar. A spokesperson for Governor Davis said that the governor was pondering the matter but that "it's premature to discuss any specific budget proposal."[25] And a spokesperson for a trade group of electricity producers suggested that the state could better spend its money on public schools, roads, and tax relief. If California were to change its approach to deregulation, the unstable political environment would discourage investment in new power plants, the spokesperson for generating interests argued.[26]

Some forecasters did suggest caution. The UCLA Anderson Forecast in December 2000 indicated that an economic slowdown—but not a full recession—lay ahead. And two of the three big private electrical utilities—Pacific Gas and Electric (PG&E) and Southern California Edison—were straining under the deregulation plan. Because they had not divested all of their power plants by then, they could not raise retail rates. But the wholesale price of electricity had reached a level at which they were operating at a loss, buying high and selling low. At a hearing of the state Public Utilities Commission in late December, PG&E reported that "we are out of credit and we are close to being out of cash."[27] The spectacle of repeated blackouts in California was about to begin.

THE 2001-02 BUDGET PROPOSAL

"Make now mistake: We will regain control over the power that's generated in California and commit it to the public good... Never again will we allow out-of-state generators to threaten to turn off our lights with the flip of a switch."

—Governor Gray Davis
January 2001 State of the State speech[28]

Despite the growing electricity crisis, Governor Davis stuck to his educational theme in framing his budget proposals for 2001-02. Traditionally, word is leaked about key features of the January budget message in advance. For 2001-02, there was to be expansion of teacher training and recruitment, a pay premium for math teachers, and enhanced math education. The academic year would be expanded for middle schoolers. At the higher education level, construction of the new UC-Merced campus was due to start.

Republicans also had plans. Assemblyman Keith Richman (R-Northridge), who was later to be involved in developing Governor Schwarzenegger's ill-fated 2007 universal health plan proposal, suggested expanding children's health insurance coverage. But Republicans more generally wanted tax cuts. Yet despite partisan debate on the budget, electricity could not be ignored.

POWER CORRUPTS

By early January 2001, there was talk of an imminent PG&E bankruptcy which could result in the inability of the company to buy electricity in the deregulated marketplace. (The firm did file bankruptcy in April.) There was also discussion of seizing power plants through eminent domain. And there was talk of the state having authority to turn on power plants ostensibly closed for maintenance. Federal assistance was not forthcoming. Washington, D.C. was by that time in the midst of the transition from Democrat Bill Clinton to GOP President George W. Bush. The new regime was not disposed to offer assistance.

At the same time as electricity was taking the focus away from the budget, there were signs that the dot-com boom was ending and the California economy was weakening. The large general fund reserve that the state had built up was likely to decline according to the legislative analyst, due to those developments.

And with PG&E and Southern California Edison running out of cash to buy electricity, the state stepped in to buy power for them through the Department of Water Resources, effectively reselling it to the utilities and consumers at a loss.

The terms of these newly-negotiated state power contracts were kept secret, officially to obtain the best price. Contract secrecy became yet another matter of controversy. Plans were proposed for a bond issue that would repay the state for its loss-producing power purchases through higher electricity bills in the future. However, there were delays in coming to an agreement on the details of the bond.

At one point, state controller Kathleen Connell—with whom the governor had feuded in the past—refused to transfer state funds for electricity purchases. The governor wanted the bond to be floated quickly so that the draw on the state treasury would end before the beginning of the new fiscal year. Nonetheless, wrangling over the bond and about electricity in general delayed the bond beyond 2000-01.

The Davis administration's position was that the state could afford such electricity purchases in the interim period before a bond was issued, given its budget surplus. Yet as my colleague Werner Hirsch and I pointed out in a February 2001 op ed in the *Los Angeles Times*, the budget was in fact already in deficit. Expenditures were in excess of revenue, a bad position to be in, even apart from the electricity purchases, when the business cycle seemed to be peaking.

A deficit at the peak could only become larger in an economic decline. Davis' finance director responded in a letter to the editor that there was no deficit, despite the figures to the contrary on the Department of Finance's own website.[29] Given a budgetary environment that the legislative analyst termed "one of the most unusual and challenging set of circumstances in recent history," California was moving into a precarious fiscal situation.[30] And despite state intervention in electricity supply, the lights kept going out.

As Table 2 indicates, Davis' approval ratings took a hit during the electricity crisis. Then, as the budget situation deteriorated, his ratings remained low. By early 2003, when his removal from office by the recall became a serious possibility, his ratings essentially had tanked.

THE MAY 2001 REVISE

As the date for the 2001 May revise proposal for 2001-02 approached, it had become clear that the dot-com boom had turned into the dot-com bust. The outlook for continued positive surprises in tax receipts on capital gains had reversed. Now the outlook was for a loss of such revenues and negative surprises.

Memories in Sacramento began to turn to the early 1990s, when a national recession and the end of the Cold War caused a major state budget crisis. Legislative Analyst Elizabeth Hill projected the January budget proposal would produce a negative reserve by the end of 2001-02 unless cuts in it were made. The concerns were not confined to Sacramento, however.

As Table 3 shows, state bond ratings were lowered in April by Standard & Poor's (S&P)—the first of multiple downgrades during the Davis era. Wall Street was watching both the deteriorating economic outlook and the drain on the state treasury from electricity purchases. The electricity bond proposal passed in May. But without a two-thirds urgency vote, the bond sale had to wait 90 days, thus pushing it into 2001-02. In the end, Davis authorized an emergency short-term loan in June—effectively a borrowing against the flotation of the longer-term bond. The state was borrowing against future borrowing.

Table 2: Voter Attitudes Toward Governor Gray Davis

	Voter Approval*	Favor Recall	
Mar. 1999	54%	Apr. 1-6, 2003	46%*
Aug. 1999	59	Jul. 1-13	51**
Oct. 1999	54	Aug. 10-13	58**
Feb. 2000	62	Sep. 3-7	55**
Jun. 2000	61	Sep. 25-28	53**
Aug. 2000	56	Sep. 29-Oct. 1	57**
Jan. 2001	57		
May 2001	36	Actual Election Result	
Sep. 2001	38	Favor Recall	55.4%
Dec. 2001	38	Schwarzenegger	48.6%
Jan. 2002	39	Bustamante	31.5%
Apr. 2002	39	McClintock	13.5%
Jul. 2002	41	Camejo	2.8%
Sep. 2002	39		
Apr. 2003	24		
Jul. 2003	23		
Aug. 2003	22		

*Registered voters.

**Likely voters.

Source: California Field Poll at:
http://field.com/fieldpollonline/subscribers/RLS2081.pdf
http://field.com/fieldpollonline/subscribers/RLS2095.pdf
California Secretary of State at:
http://www.sos.ca.gov/elections/sov/2003_special/recall_question.pdf
http://www.sos.ca.gov/elections/sov/2003_special/gov.pdf

Table 3: California General Obligation Bond Ratings

	Fitch	Moody's	Standard & Poor's
As of Jan. 1999	AA-	Aa3	A+
During 1999			AA-(Aug.)
During 2000	AA(Feb.)	Aa2(Sep.)	AA(Sep.)
During 2001		*Aa3(May)* *A1(Nov.)*	*A+(Apr.)*
During 2002	*A(Dec.)*		*A(Dec.)*
During 2003	*BBB(Dec.)*	*A2(Feb.)* *A3(Aug.)* *Baa1(Dec.)*	*BBB(Jul.)*

Note: Interim warnings by the rating agencies that may have been issued between rating changes are not included. Downgrades are in italics.

Source: California State Treasurer. Available at: http://www.treasurer.ca.gov/ratings/history.asp

When the May revise did come out, it included various cuts. However, Governor Davis tried to preserve as much of his January education proposals as possible. "I'm not going to let our commitment to education backslide," he said.[31] But in fact the education proposals were trimmed. For example, the proposed lengthening of the middle school academic year was retained, but the number of added days was reduced.

Even with the various May revise spending cuts relative to January, and assuming that the electricity bond would repay the state for its power purchases, the state would still run a deficit and pull down its reserve. As a result, state bond ratings were lowered by Moody's. Republicans criticized the governor's plan as fiscally imprudent. And the legislative analyst warned that even the slimmed down May revise would lead to a negative reserve.

Governor Davis, however, denied that the reserve would go negative. "Reserves are for rainy days... We're getting out our umbrella," he said.[32] By June, state Senator Steve Peace (D-El Cajon)—later to

become Davis' finance director—said the slim reserve projected by the governor's May revise "ain't going to last ten days in a softening economy."[33]

Not surprisingly, the June 15th technical deadline for the legislature to pass a budget came and went without a deal. Cuts were made, however, in various legislative proposals. Lengthening of the middle school year was dropped, for example. A sticking point was the 0.25 cent cut in the sales tax which would end automatically by formula on January 1, 2002 due to revenue declines. Republicans wanted the reduced rate to continue, i.e., to override the existing formula and keep the cut in place. With a legislative stalemate, the new fiscal year began on July 1 without a budget.

NEGOTIATING THE 2001-02 BUDGET

It took until July 26th for a budget deal to be reached and signed into law. Assembly speaker Robert Hertzberg (D-Sherman Oaks) suggested that the Republicans were holding back on a budget deal to "embarrass the governor" by depriving him of an on-time budget.[34] There was discussion of delaying the formula-linked sales tax rise, rather than blocking it entirely as Republicans had wanted.[35] Another possibility was changing the formula in some way. Eventually, enough Republican votes to reach the two-thirds hurdle were obtained in the Assembly by dropping the sales tax issue and offering a deal for rural districts that benefited agriculture and other interests there.

Once a budget had passed the Assembly, it was thought that the process would be easier in the Senate since only one Republican vote was needed. However, various trailer bills linked to the budget in the Assembly failed to obtain sufficient Republican approval, thus delaying the process there.

After a lack of success in the Assembly on the trailer bills, the Senate took up the budget and a new deal was cut in the upper house.

Under the eventual Senate budget plan, the sales tax increase formula was modified but in a way that it would still trigger the 0.25 cent hike on January 1, 2002. In addition, among other inducements, a proposition would be placed on the March 2002 ballot earmarking the sales tax on gasoline (not to be confused with the gas tax itself) for transportation. The Senate's passage of the budget with the ballot measure broke the stalemate in the Assembly over the trailer bills. The governor signed the budget after vetoing about half a billion dollars of spending. Particularly hit by vetoes were community colleges, although some funding was later restored. In theory, a reserve in the general fund of $2.6 billion was forecast for the end of 2001-02. But in fact, a substantial negative reserve resulted.

A series of events delayed flotation of the electricity bond, including the September 11th terrorist attacks - which also made the economic outlook more uncertain. Drops in revenue below forecast levels added to the precarious fiscal climate. By October, the governor told state department heads to plan for major budget cuts. A hiring freeze was ordered. By November, Davis was calling for mid-year spending cuts and freezing various funds over which he had control.

Borrowing to deal with state deficits was raised as a short-term solution to what was now acknowledged as a budget crisis. There began to be discussion of having the state issue Revenue Anticipation Warrants" (RAWs), that would allow borrowing across the fiscal years, i.e., from 2001-02 to 2002-03, particularly since the electricity bond was on indefinite hold at the Public Utilities Commission. Another possibility that began to be discussed was borrowing against future tobacco settlement revenue.

Given the budget and electricity meltdowns, various Republican candidates for governor in the November 2002 election began to surface, as Davis looked more and more vulnerable to a challenge. Included on the list were Los Angeles Mayor Richard Riordan, Secretary of State Bill Jones, and businessman William Simon, Jr.[36] All of the candidates pointed to California's fiscal problems and attributed them to Davis' lack of prudence. "Spending like a drunken sailor," was Riordan's description.[37] Riordan was widely viewed as the most effective opponent in a race against Davis. But he was also seen as someone who might have trouble—because of his centrism—in winning a Republican primary.

BUDGETING FOR 2002-03 IN AN ELECTION YEAR

"With the same resolve we demonstrated during the energy crisis, we will squarely confront the current economic downturn and its consequences."

—Governor Gray Davis
2002 State of the State address38

With revenues adversely affected by recession, the need to conserve cash became an element in budgeting. State Treasurer Phil Angelides proposed a restructuring of state debt so that debt service would be more back-loaded, i.e., that outflows for debt service would be delayed. Potentially complicating state budgeting was the above-mentioned ballot proposition (Prop 42) that was scheduled to appear on the March 2002 ballot as part of the earlier budget deal for 2001-02. Prop 42 earmarked the sales tax on gasoline for transportation rather than the general fund and when put to the electorate passed by a wide margin.

Despite the revenue problem, the governor did not propose new taxes in his January budget proposal. But various fees were to increase. The proposal acknowledged that a deficit would in fact be occurring during the current (2001-02) fiscal year but assumed nonetheless that 2002-03 would end with a slight positive reserve. However, some of that reserve would consist of borrowed tobacco money and of borrowings from other sources including delayed payments to state pension plans.

The January budget plan assumed various funding would flow from the federal government that in fact might not be forthcoming. And the legislative analyst suggested that required payments to K-14 education under Prop 98 were underestimated in the Davis proposal. By late February, she also estimated that his revenue forecasts were significantly overoptimistic. The only good news was that California's electricity usage was constrained by the state's economic slump, making it unlikely that a renewed period of blackouts would occur.

PRIMARY EVENTS

Republican gubernatorial hopeful William Simon characterized the Davis budget as "shell games and fuzzy math."[39] Foreshadowing a favorite proposal of Arnold Schwarzenegger when he became governor, Simon pushed for a large rainy-day fund to cushion the state budget from economic downturns. Senate president John Burton, while officially favoring Davis' re-election, managed to be photographed hugging Republican Richard Riordan and made various off-handed criticisms of the governor. And as bad revenue news accumulated, the governor had to scrap his teacher bonus program as part of midyear budget cuts.

It is not unknown for incumbent California governors seeking re-election to try and influence the selection of the other party in the hopes of facing a weaker opponent.

However, such cross-party efforts can be risky. Governor Pat Brown, seeking a third term in 1966, thought Ronald Reagan was his preferred opponent on the assumption that a movie actor would not be considered by voters as a serious candidate. As it turned out, Reagan was a strong contender and defeated Brown. Intervention in the other party's primary, in short, can lead to unintended results.

Nevertheless, Gray Davis thought that Riordan, as a centrist candidate, would be his strongest rival among the Republicans and ran TV ads to undermine him. Ostensibly, the ads criticized Riordan as a flip-flopper on the abortion issue. However, the ads were intended to emphasize that Riordan, although a Catholic, was taking a pro-choice position. Davis was undoubtedly right about Riordan being the strongest candidate in 2002 and his strategy did help Simon beat Riordan in the March primary. (Jones came in third.) However, Davis' intervention in a Republican primary was remembered in the 2003 recall as a political manipulation to the governor's ultimate detriment.

PRELUDE TO A SUMMER STALEMATE

Given the squeeze on state revenue, various public-sector unions pushed for a tax increase. However, in an election year, Governor Davis was reluctant to endorse such a strategy. In addition, a tax increase would require a two-thirds vote in the legislature—an unlikely outcome. But by April, Davis was discussing the possibility—as something he didn't want to do but could not rule out—of suspending Prop 98's guaranteed funding for K-14. "I don't want to go there right now," the governor said.[40] There was also talk of delaying the opening of UC-Merced.

Still, the state was likely to run short of cash absent some solution. Part of the problem was that the electricity bond had not yet been floated and it was unclear when it could be issued. Controller Kathleen Connell announced there would need to be an issuance of Revenue Anticipation Warrants (RAWs), short-term borrowing that crosses the fiscal year. By the May revise, the governor was proposing to undo past cuts in the Vehicle License Fee (car tax) for a one-year period—although delayed until after the November election. A tobacco tax would be part of the package. And there would be cuts in Medi-Cal and other programs.

Legislative Democrats pushed for increased income tax rates in the higher brackets, but Republican support was not available for such a tax hike. However, the Senate, which required only one Republican vote to obtain the needed two thirds, did pass a budget with a jump in the car tax for one year, a tobacco tax, and other revenue raisers. The one Republican who provided the vote—Senator Maurice Johannsen (R-Redding)—was subsequently excluded from Republican caucus meetings in early July. The deal with him reportedly involved not closing a private prison in his district and other considerations.[41] In the Assembly, however, four Republican votes were necessary and no budget was passed when fiscal 2002-03 began on July 1.

A LONG HOT SUMMER OF DELAY

In the background of the stalemate were the impending gubernatorial and other elections in November. William Simon was having trouble in fundraising and there was controversy over his unwillingness to release his tax returns. And Governor Davis had a scandal simmering about state computer contracting with Oracle Corp. The California state auditor also criticized inefficiencies in the management

of state prisons. As the heat of the campaign increased, the duration of the budget delay also increased. Eventually, the state was to go over two months without a budget, a record not to be exceeded again until the summer of 2008 under Governor Schwarzenegger.

The new fiscal year began with the usual warnings that certain payments could not be made without an enacted budget, and with conflict between Governor Davis and Controller Connell over what payments would be made. A legislative analyst's report suggested that if the current trajectory of revenues and spending were continued, the state would face deficits over a multiyear period, i.e., that economic growth alone was not expected to repair the problem.

As the budget stalemate persisted, Governor Davis' popularity with voters was certainly not enhanced. However, Republican gubernatorial opponent Simon seemed to be having difficulties convincing prospective voters that he would do a better job than Davis or even in raising funds to support a campaign to tell them so. There were reports that Simon was under an IRS investigation concerning his income taxes and a tax shelter he had used of uncertain validity. But he continued to refuse to make his returns public, saying he would do so only if elected. As pressure mounted on the issue, Simon eventually allowed reporters to see the returns, but not to copy them.

On the other hand, a Field poll suggested that Prop 49 scheduled for the November 2002 enjoyed strong public support.[42] Prop 49 earmarked funding for after-school activities and was supported by actor Arnold Schwarzenegger. Schwarzenegger was interested in possibly running for governor in some future election. His political advisors had suggested sponsoring a ballot initiative to introduce him to the public as a serious figure. At the time, no recall was envisioned so the earliest Schwarzenegger could have been contemplating a run for the governorship was 2006. But Schwarzenegger wasn't shy about his ambitions. "That is my favorite job in a political arena. Being CEO of a state—that, to me, is interesting."[43]

By August, although various proposals on the budget were debated in the legislature – including a major increase in the tobacco tax - none seemed close to breaking the stalemate. Without a budget, state employees were still receiving their full pay although a legal challenge to paying them more than the minimum wage had been mounted. Various other providers of state services were not being paid at all and Cal Grant scholarships were also delayed. Republicans charged that Davis was "alarmingly disengaged" from the budget process.[44]

In late August, Assembly Republicans and Democrats seemed to be moving towards a deal. It involved certain changes in business taxes that would bring in more revenue in the short term (although less in the future), various spending cuts, and some cosmetic deferrals of expenditures into the next fiscal year. But the deal also involved a possible ballot proposition that would earmark a portion of the general fund for infrastructure improvements. In the end, agreement was reached in the Assembly, but without the infrastructure proposition. The Assembly version of the budget was then passed by the Senate.

In signing the budget in early September 2002, Davis called the process of negotiations "an arduous and difficult task." Gubernatorial rival Simon charged that the new budget was "a fabrication that was neither balanced nor fiscally responsible."[45] However, by that time Simon was looking increasingly to be a likely loser in November, albeit with Davis seen by voters as being only the less bad of a poor choice.

THE 2002 GENERAL ELECTION

Davis refused to attend a debate in mid-September, leaving Simon to debate the Green Party candidate. (Both major party candidates did debate in October.) He vetoed a bill that would have allowed illegal immigrants to obtain drivers' licenses, even though the bill might have attracted some Latino voters. (The license issue arose again in the 2003 recall when Davis signed a similar bill, hoping to attract Latino votes). A Simon TV ad purported to show a photo of Davis accepting a campaign check inside a state office, an act which would have been illegal. But it turned out that the location was in a private home and therefore legal, a revelation that ended up casting a negative light on Simon rather than Davis.

On Election Day, Davis won 47 percent to Simon's 42 percent (with the remainder going to third parties). Such a narrow winning margin was not a good showing for an incumbent—especially one who had spent roughly twice as much on his campaign as his particularly weak opponent. The apparent voter unhappiness of 2002 would ultimately be reflected in the 2003 recall.[46] Of more immediate significance to the budget was a very narrow victory by Democrat Steve Westly over Republican state senator Tom McClintock for controller. The conservative McClintock, had he won, might well have refused to float the Revenue Anticipation Warrants (RAWs) that were needed by the time of the next budget. (For odd reasons, RAWs are floated by the controller rather than the Treasurer.) In the official tally, the two controller candidates were separated by less than 17,000 votes.

The Schwarzenegger-backed Prop 49 earmarking funds for after-school activities, in contrast, was adopted by a margin of over one million votes. Just as Simon was not seen as a viable vehicle for addressing voter concerns about the budget, so—too—were some Democratic legislative candidates. Democrats lost two seats in the Assembly and one in the Senate, thus making it more difficult for them in future budget or tax debates to obtain the needed two-thirds majority.

On the other hand, the election led to internal feuding within the GOP. State Republican chair Shawn Steel complained that big business had engaged in a "betrayal" of the party by underfunding Simon and McClintock. Steel vowed the GOP would no longer support tax breaks for large corporations.[47]

It was soon apparent after the election —if it had not been before—that the 2002-03 budget was in fact in deficit and that more fiscal difficulties lay ahead. "There is no easy way out of this predicament," the legislative analyst said in mid-November.[48] Governor Davis called a special session of the legislature in December to deal with the unraveling budget and recommended midyear spending cuts and layoffs. Student fees were raised at UC and CSU campuses. The resignation of finance director Tim Gage was announced with the explanation that he needed to spend more time with his family. And the state's credit rating was cut by Standard & Poor's and by Fitch.

The election—while a win for Davis—also turned him into a lame duck due to term limits. Davis' lack of close relations with other elected Democrats surfaced even before the election when Lieutenant Governor Cruz Bustamante, running for his own re-election, raised the Oracle computer contracting scandal in a TV ad. In the post-election period, Bustamante—who became the *de facto* Democratic alternative in the 2003 recall—said of Davis, "I'm not his yes man."[49]

After the election, various politicos had a meeting with the editorial board of the *Sacramento Bee*. Davis' campaign advisor Gary South chastised Republican state senator Jim Brulte at the meeting over the lack of viable GOP candidates for office at the statewide level.

"You have no candidates. Now, I know what

you're going to do; you're going to get somebody, oh, Schwarzenegger, he's rich, he's famous, he's got a wife who's a Kennedy... (But) running an initiative campaign like Proposition 49 is not even in the same ballpark as running for governor... He might think it is... But it's not."[50]

DAVIS' FINAL BUDGET: 2003-04

"I'm greatly honored to be able to lead California for the next four years. There's no question I've been tested by adversity, but I'm stronger and tougher and more determined to do a good job."

—Governor Gray Davis
interviewed in early January 2003[51]

Unlike what was possible at the beginning of his first term, Governor Davis could not promise major new gains in education as his fifth year and second term in office commenced. There was talk about obtaining additional support from the federal government, protecting homeland security (post 9-11), and creating jobs by releasing previously-authorized bond funds for infrastructure. In his State of the State address, the governor asked for more authority to make midyear budget cuts, a proposal which Republican legislators supported but to which Senate President John Burton responded with "not in my lifetime."[52] Davis vowed to reject any budget that did not contain structural reform (the precise nature of which was not spelled out).

When his January budget proposal was released for 2003-04, it contained proposals for income tax, sales tax, and tobacco tax increases. Senate minority leader Jim Brulte, however, quickly declared that he was "not going to vote for a tax increase."[53] A new wrinkle in the proposed tax plan was that the revenue would be shifted down to counties—framed as fiscal "realignment"—along with responsibilities for various state services. By pushing revenue and programs down to the local level, the proposal avoided Prop 98's requirement that new state revenue—such as would accrue under the governor's tax increase proposal—be partly earmarked for K-14 education. Despite the budget squeeze, an expansion of Healthy Families was proposed, i.e., covering more working poor children with public health insurance. But there were cuts in other social welfare programs. Additional but uncertain revenue from Indian gaming was projected. The governor suggested the Regents should invest UC pension funds in home construction to create jobs and affordable housing—a suggestion that went nowhere.

One proposal that Davis did not make at the time, but that was already percolating in Sacramento, was triggering a hike in the Vehicle License Fee (car tax). When the car tax had been cut earlier—taking money away from local governments which the state then backfilled—a trigger provision had been included. The trigger would raise the tax back up if there were insufficient state funds for the backfill. In the prior year, Davis had proposed raising the car tax but his proposal then was not accepted in the earlier budget deal.

It was unclear exactly who would pull the trigger or exactly how a determination of insufficient funds would be made. Later in 2003, however, as the recall loomed, the car tax trigger became a major campaign issue. But in January, the governor made a point of explicitly opposing any increase in the car tax or even enacting a bill that would clarify the trigger. However, there was pressure from local governments to hike the car tax. Jerry Brown, then mayor of Oakland, suggested that Davis "with the stroke of a pen" could raise the car tax so that "we can restore vital police services."[54]

For local governments, the issue wasn't the car tax *per se* but that the governor was proposing that the state stop paying the backfill while not raising the tax. It appeared that Davis—realizing that the car tax was a major issue for Republicans—was resisting the

possibility of such an increase. He may have hoped to have a car tax increase as fiscal bargaining chip later in the process. Or he may have hoped that by siding with the Republicans at this stage of the process he might make them more cooperative later.

But keeping the car tax off the table proved difficult. Legislative Analyst Elizabeth Hill criticized the governor for depriving local governments of the backfill. "The state made a policy decision to give tax relief (when the car tax was cut), and we think that the same entity of government that makes the decision about tax relief should bear that burden."[55]

By late January, the Assembly had proposed a bill that would make midyear spending cuts in 2002-03, but effectively linked the cuts to Davis pulling the car tax trigger. Davis indicated he would veto such a bill, saying he wanted a "total budget solution" instead.[56] However, he did not rule out the possibility that the trigger would eventually be pulled under existing law if the budget problem worsened. Eventually, the governor and the controller produced a legal opinion that the car tax increase could be triggered by an opinion of the finance director. With that opinion on the record, the legislature then approved some midyear spending cuts.

AN ENDANGERED GOVERNOR?

Both the legislative analyst and legislative Republicans argued that Davis' proposal for a midyear correction of 2002-03 and for the coming 2003-04 had overstated the problem, perhaps to dramatize the real dilemma and pressure the legislature. The new finance director —former state senator Steve Peace—attributed alternative projections to a "green eyeshade debate" over methodology.57 The controversy centered around estimates of the so-called "workload" projections, i.e., what would happen if no budget changes were made. If the projection is exaggerated, but offset by equivalent cuts in spending, the budget predicament is made more dramatic, possibly influencing legislative cooperation. There is no *net* effect on the projected outcome, but the large gross dollar magnitude might jar the legislature into going along.

Another part of the problem was the time dimension. Multiyear projections are routinely compared with the one-year general fund budget, thus producing a large and shocking comparative number. This apples-and-oranges approach—multiyear vs. one year —may simply confuse the process of fiscal decision-making. It is certainly questionable whether sowing confusion produces legislative cooperation or better eventual results.

Davis was not the first governor to use the apples-and-oranges approach to budget presentation approach nor, as it turned out under Schwarzenegger, the last. Nonetheless, the debate over the size and presentation of the fiscal problem created a credibility issue for the governor. Lack of any obvious budget agreement in February led Moody's to join the other two rating agencies in downgrading California bonds, the first of three such downgrades by that agency during calendar 2003.

At about the time the car tax veto was becoming the focus in Sacramento, recall papers were served on the governor, charging him with "gross mismanagement of California Finances."[58] Initially, the threat of a recall was not taken very seriously by the Davis administration. Serving such papers is merely the first step in the recall process, allowing a voters' petition to be circulated.

Two prior recalls against Davis had been in fact been served by groups angry over immigration and about electricity, but those efforts had dissipated. Recalls had also been filed against all earlier governors going back to the mid-1930s, except for two, without success.[59]

"This is the sort of thing that they do all the time," said Gary South, a Davis political advisor.[60] News of the 2003 recall being served when it first surfaced did not even make the front page of the *Sacramento Bee*, although it was reported on an interior page.

By mid-February, however, the possibility of a recall began to taken more seriously, although Davis reportedly told state attorney general Bill Lockyer as late as May that the recall would not qualify.[61] While the link back of the recall to some Republicans was apparent, Davis was also vulnerable because of limited allies within his own party.[62] Early on, however, Republican legislative leaders were leery of endorsing the recall. Groups such as the California Business Roundtable opposed a recall as late as June.

Anyone—including a Democrat—could run for governor if a recall made it on to the ballot so the result might be substituting one Democrat for another. A new Democrat would not be termed out in 2006 and might prove to be more popular than Davis. In the early stages of the recall, key Democrats eschewed any ambitions to run. But, of course, they could always reverse course (as Lieutenant Governor Cruz Bustamante ultimately did). Assembly minority leader Dave Cox initially opposed the recall; "There's a difference between being incompetent and corrupt," he said.[63] Nonetheless, the threat of a recall gave traditional Democratic allies some leverage over the governor on budgetary matters.

The president of the California Teachers Association (CTA) pointedly noted, when asked about the recall, that "Gray Davis is not popular with the CTA, or teachers."[64] The CTA tended to be affiliated with Democrats but could be pragmatic about choosing allies. CTA had in fact supported Arnold Schwarzenegger's Prop 49 the previous November which won voter approval. Prop 49 earmarked funding for after-school (and therefore school-related) activities. And CTA was anxious to defend Prop 98's school funding guarantees as the budget situation deteriorated. Moreover, it was considering filing still another initiative earmarking a tax increase for education.

Other public sector unions had potential gripes with the governor. As part of collective bargaining proposals made by the Davis administration in March 2003, came a suggestion for furloughs—unpaid involuntary days of leave—a device used in the 2008-09 budget crisis. Some state unions with contracts already in effect were asked to reopen them for concessions. As might be expected, there was little union enthusiasm for such proposals.

When an elected official is served with a recall, he or she can provide a response before the petition is authorized for circulation. Governor Davis, rather than ignore the effort (one option for such an official), chose to argue that the recall was the product of sore losers in the 2002 election and of right-wingers who were blaming him for a national recession. His response became part of the material petition circulators would have to include in future signature gathering. It eventually became part of the official voter pamphlet when the recall appeared on the ballot.

It was unclear until late April whether the recall proponents would have sufficient resources to mount a credible petition drive. Up to that point, they did not have the substantial resources needed to pay for gathering the required signatures. Although there was talk of using the Internet to circumvent the need to hire sufficient paid signature gatherers, it appeared unlikely that a spontaneous uprising via the Internet could succeed. However, Congressman Darrell Issa (R-Vista), who had become independently wealthy in the car alarm business, decided to contribute to the recall campaign in the hopes of becoming governor.

Issa turned out to be a more serious gubernatorial candidate in his own mind than in the voters'. Despite his success in the car alarm business, he had in his youth

been arrested for car theft, although the charges were dropped. More recently, in sensitive the post 9-11 period, he had charged that airline officials had kept him off a plane to Saudi Arabia due to racial profiling of his Middle Eastern background. The airline in question said he had simply arrived for the flight too late. These controversies dogged his abortive campaign.

But once serious financing had entered the campaign via Issa, it became a real threat to Davis and began to color the budget process.[65] More and more attention had to be devoted to the recall in an administration which insisted on gubernatorial attention to everything. As Republican legislators were pulled towards support of the recall, they had less incentive to produce an on-time budget or otherwise cooperate with the governor. Arnold Schwarzenegger began to loom as a threat in a possible recall, even before he formally announced his candidacy. At a dinner celebrating the 25th anniversary of Prop 13 in June, Schwarzenegger quipped, "I just forgot our state governor's name, but I know that you will help me recall him."[66]

THE BORROWING SOLUTION

Since Republicans were rejecting a tax increase – but were not willing to specify a cuts-only package to resolve the budget dilemma—they needed an alternative plan. Essentially, the only way out for them was to propose to borrow, a "rollover of a deficit" as Senate minority leader Jim Brulte termed it.[67] Such an approach had been used by Republican Governor Pete Wilson during the budget crisis of the early 1990s.

When the borrowing option fully surfaced, Davis initially was reluctant to consider it and termed the Republican plan as based on "fuzzy math.[68] Nevertheless, the borrowing idea steadily crept into the debate. There were already proposals on the table to sell state bonds in order to cover state public pension obligations. Borrowing for a specific expense within the budget is not much different in concept from borrowing for general expenses. But it was thought that such a bond would avoid the constitutional requirement that voters approve general obligation debt increases.

Adding to the pressure to come up with new borrowing was the fact that borrowing that had already been built into the current year's budget in the form of a tobacco settlement bond. But in April that bond was indefinitely delayed. There were concerns at that point that cigarette maker Philip Morris might be forced into bankruptcy due to a pending lawsuit. Such a bankruptcy would make a debt security that was dependent on tobacco company revenue difficult to float.

Moreover, an important element of the January budget —realignment, i.e., pushing revenue and programs to the local government level—was called into question by the Legislative Counsel. A purpose of realignment, as noted earlier, was to reduce state education obligations under Prop 98, which would otherwise accrue under the governor's tax increase proposal. In short, the more that alternatives to general borrowing of the type the Republicans were proposing were stymied, the more attractive their rollover borrowing appeared, simply by default.

Davis' own Department of Finance began to flirt with the rollover idea in early May, shortly before the May Revise, although the governor indicated that he was still "not prepared to say" whether or not he supported the idea.[69] Ultimately, however, rollover became part of the governor's approach. And the idea was inherited and adopted by Davis' successor, Arnold Schwarzenegger, after the recall election.

THE MAY 2003 REVISE

When the May Revise for 2003-04 was released, it had largely dropped the realignment approach, probably because of the legal uncertainty over whether it would avoid Prop 98's claim on any added state revenue. Governor Davis included a rollover element as proposed by the Republicans, but continued to include various tax increases including a half-cent hike in the state sales tax. Given the two-thirds requirement needed for tax increases or for the budget more generally, however, it was unclear how Davis expected his new proposal to fly. Davis did assume that the car tax would be increased by the trigger mechanism, something not requiring a two-thirds vote in his view.

The legislative analyst provided a cautious note, but indicated that, *if* everything went exactly as planned, the governor's rollover plan could work. However, any borrowing plan would have to persuade Wall Street to finance the rollover. Wall Street was already being asked for a short-term loan in the form of Revenue Anticipation Warrants (RAWs), which were secured in mid-June.

A budget stalemate beyond July 1 would create investor doubts over a more extensive rollover. And the rollover plan—if it entailed long-term borrowing—would have to deal with the constitutional requirements that general obligation borrowing must be for specific projects—not normal operations—and must be approved by a vote of the people. An attorney with the conservative Pacific Legal Foundation pointed to the constitutional issue in an op ed, probably intended as a warning that the Foundation would likely file a legal challenge to any borrowing plan it considered unconstitutional.[70]

Not surprisingly, given the growing magnitude of the budget problem and the complicating fact of the recall movement, there was no budget agreement at the end of June. And the legislature remained polarized. Two moderates, Republican assemblyman Keith Richman (Northridge) and Democratic assemblyman Joe Canciamilla (Pittsburg), tried to put together a compromise budget. But they ended up isolated from their more partisan legislative colleagues.

Adding to the turmoil was an opinion of the Legislative Counsel that the car tax trigger could not in fact be pulled, since it was based on the state having "insufficient" funds for the backfill. Her view was that if there was *any* money left in the general fund sufficient to cover the backfill, the tax could not be automatically raised. That opinion gave support to Republicans who threatened a court challenge to a hike in the car tax. Meanwhile, the fact that RAWs had been floated in June would keep the state in cash well into the summer—reducing the incentive to come to a quick budget compromise.

STALEMATE AND CIRCUS

Once the state began its fiscal year without a budget, the usual forces were set in motion. State controller Steve Westly warned that certain payments could not be made absent a budget. Moreover, a recent court decision would lead to state workers being paid only the minimum wage, he indicated, with the rest of their pay held up until a budget was enacted. The gridlock on the budget occurred despite the fact that by the time the new fiscal year began, the governor and both parties in the legislature were in favor of a rollover borrowing plan, pegged at $10.7 billion. However, Republicans did not want to impose a tax increase to pay off the loan; Democrats wanted an earmarked tax hike tied to it.

Early in the new fiscal year, the recall moved from a possibility to a near-certainty. On July 7, recall organizers announced that they had collected enough signatures to force an election and that the secretary of state Kevin Shelley would be receiving the petitions shortly. Although a Democrat, Shelley was anxious to be viewed as acting impartially and efficiently, perhaps with a future career goal in mind. And he generally was so perceived in handling the recall's mechanics. Shelley's goal, however, meant that Davis could not hope the recall would somehow be delayed or derailed because a Democrat was the state's chief election officer. (Ironically, like Davis, but a year and a half later, Shelley's political career also came to a sudden halt when he resigned in the midst of a campaign funding scandal.)

Even though the recall campaign had officially ended once the signatures were gathered, Darrell Issa continued to air anti-Davis ads on the radio, now focused on his own candidacy for governor should Davis be ousted. Yet Issa's opinion poll results put him behind other Republican possibilities. Various lawsuits were filed to block the recall, but in the end—despite some legal obstacles—it was certified and plans for the election went forward. The date of the election was set by the Lieutenant Governor as October 7. Even before a budget was ultimately signed, voters were bending toward the recall option.

By the third week in July, there was both a focus on the budget and various distractions apart from the recall, all of which created a chaotic atmosphere. Big student fee increases were approved for UC and CSU in anticipation of whatever budget was ultimately approved. Some Democrats were proposing to ask the state Supreme Court to overturn the two-thirds budget and tax rules, citing a vaguely-related case in Nevada. An initiative, defeated in 2004, was also circulating aimed at cutting the two-thirds hurdle to 55 percent.[71] Another initiative, which would outlaw the state's keeping racial statistical records, was likely to end up on the recall election ballot, assuming the recall occurred. It became Prop 54. In addition, there would be a ballot proposition (Prop 53) earmarking a portion of the general fund for infrastructure, a leftover from the budget deal for 2002-03. (Props 53 and 54 were defeated in the special recall election.)

Davis' finance director Steve Peace attracted unwanted media attention by screaming "We need a budget" at a Republican assemblyman and was reportedly in tears at the time. He also denounced some Democrats who had inadvertently strategized about the budget near an open microphone as "a group of fringe Democrats having a goofy conversation."[72] When the recall was officially certified on July 23, Davis said he was going to fight it "like a Bengal tiger."[73] A recall organizer characterized the atmosphere in Sacramento: "Set up a tent; the circus will come."[74] Standard & Poor's cut its rating of California bonds to BBB.

BUDGET DEAL

Announcement of the recall certification seemed to expedite legislative budget negotiations. On July 24, an outline of a deal was reported, although a final version was not sent to the governor until July 29. It contained a rollover but—in a partial victory for Republicans —without a tax increase. Their victory was partial because a business tax credit was eliminated and various fees were increased. Nevertheless, the ultimate package contained more cuts than Democrats had wanted and the deal tilted toward the Republican side. The opening of the new UC-Merced campus was delayed. Governor Davis signed the budget on August 2, despite his earlier pledge not to sign any budget that failed to contain structural reform. He vetoed less than $1 million of spending.

An elaborate, and legally questionable, strategy was developed as part of the budget accord to enable a rollover bond flotation. A half-cent of the sales tax

normally going to local governments would be cut. The state would raise its part of the sales tax by half a cent and semi-earmark that revenue to pay off the bond. An equivalent amount of property tax would be taken from school districts and used to compensate local governments for their half cent loss. The state would then reimburse the school districts for their loss of property tax revenue that had been given to the locals. This three-step approach—known as the "triple flip"—allowed sales tax earmarking without a sales tax net hike. By itself, however, it did not resolve the constitutional issues of floating bonds for general operations and without a vote of the people.

After the recall, when Governor Schwarzenegger adopted the rollover approach from Davis, he retained the triple flip—which had the inadvertent effect of making future state expenditures contingent on the ups and downs of local property tax receipts. But Schwarzenegger dealt with the constitutional issues by putting the matter to the voters in the form of Props 57 and 58 of 2004. He also raised the level of the bond authorization well above Davis' $10.7 billion which gave him a future cushion of borrowing ability should another fiscal crisis arise.

In contrast with Schwarzenegger's later rollover, Davis' version sought to avoid the constitutional constraints by creating an entity outside the general fund. The legislature would use the entity to repay the bond by appropriating money annually to service the debt, technically on a discretionary basis. The uncertain legal argument was that since the legislature formally did not *have* to appropriate the funds (the half-cent revenue), the bond did not represent constitutional "debt." It is unlikely that such an approach could have succeeded since a court challenge to the constitutionality of the bond would have scared off potential investors. That is, even if the elaborate scheme was eventually found constitutional, the uncertainty posed by litigation in real time would likely have killed it as a practical matter.

THE BUDGET BECOMES A LEGACY

"I have to stay focused. Believe me, I do not like (the recall). But that and a dollar will get me a cup of coffee."
—Governor Gray Davis[75]

"The public doesn't care about figures. They have heard figures for the last five years. Figures and drafts and percentages. And all kinds of things. What people want to hear is are you willing to make the changes? Are you tough enough to go in there and provide leadership"?
—Recall candidate Arnold Schwarzenegger[76]

Once a budget was signed, increased public attention was drawn to the recall. In a recall election, voters first indicate whether they favor or oppose recalling the official involved. Then, regardless of their personal vote on the recall question itself, they choose among competing candidates (other than the targeted official). If the recall succeeds, the candidate with the most votes takes the office and the targeted official is removed; there is no runoff. It is possible, therefore, for just under 50% of the voters to oppose the recall and for some candidate with well under 50% to be elected as the replacement. As Table 2 shows, in the end, the recall passed with 55.4% of the vote and Schwarzenegger received a respectable 48.6%, well ahead of any rivals.

Organized labor largely backed Governor Davis in opposing the recall effort. Funds were allocated to tie up signature gathering firms recall proponents might use by paying them to circulate a petition—of no legal significance—in support of Davis. The Democratic strategy of not fielding a candidate soon eroded and Lieutenant Governor Cruz Bustamante ultimately put his name on the ballot after U.S. Senator Diane Feinstein made it clear she would not run. (Insurance Commissioner John Garamendi announced he would run but then reversed himself and left the Democratic field to Bustamante.)

The Democratic strategy became "no" on the recall but (just in case it succeeded anyway), "yes" on Bustamante. Congressman Darrell Issa, who had funded the recall campaign, tearfully dropped out and Arnold Schwarzenegger dropped in. Schwarzenegger announced his candidacy on the *Tonight Show*, and appointing former Governor Pete Wilson as his campaign co-chair.

When Schwarzenegger became a candidate, Richard Riordan—whose campaign a year for the Republican nomination had been undermined by Davis—bowed out as a potential candidate. William Simon—the Republicans' losing gubernatorial candidate in 2002—was in the recall race for a time, but also bowed out eventually as did Peter Ueberroth. Ueberroth was well known in Los Angeles for successfully supervising the 1984 Olympics. But his leadership of Rebuild L.A., an organization set up after the Los Angeles Riot of 1992, was not the success his Olympic efforts were.

Conservative state senator Tom McClintock was the only significant Republican left—other than Schwarzenegger—for voters to choose by the time of the recall election. Although McClintock was arguably the most knowledgeable about the state budget, he never proposed an overall plan for fixing it. But he did propose zeroing out the car tax—not just undoing Davis' car tax increase—and imposing a spending cap on the state.

Independent columnist Arianna Huffington entered the campaign but eventually dropped out towards the end. Her campaign centered on ridding state government of "special interests." She argued for shifting toward higher corporation taxes and higher taxes on commercial property—a position that would require modification of Prop 13—but favored undoing Davis' car tax increase. In an era when use of the Internet for political campaigns was still developing, her website included amusing animated cartoons.

Green Party candidate Peter Camejo focused on tax increases on the wealthy and reducing fees at UC and CSU. As did Huffington, he favored raising taxes on commercial property. Because of the ease of getting on the recall ballot, well over 100 minor candidates were listed, some apparently running for the fun of it and others to attract publicity.

Democrat Bustamante, who ultimately came in second in the recall, promised to reduce the car tax and substitute taxes on higher-income individuals and on tobacco. If the legislature would not approve his "tough love" budget program, he suggested he could go directly to the voters through a ballot proposition to implement his plan.[77] Schwarzenegger did not propose a detailed fiscal plan. But did say that he would undo Davis' car tax increase and that he would propose a constitutional spending cap, a concept he raised repeatedly—and without success—during his two terms in office.

Schwarzenegger quickly distanced himself from economic advisor and famous financier Warren Buffett who criticized Prop 13's effect on property taxes. And he promised there would be no new taxes, except in emergencies. He was dogged by allegations of sexual harassment and made various apologies for past behavior during the later days of the campaign.

However, Schwarzenegger generally characterized himself as a practical centrist who favored abortion rights—despite his Catholic background—and gun control. As a wealthy businessman, he would not need support of special interests, Schwarzenegger argued. But his definitions of special interests seemed confined to unions and Indian gaming tribes. Other commercial interests did contribute to his campaign and continued to do so during his governorship. Schwarzenegger promised to institute an "audit" of the state government to uncover inefficiencies.

Governor Davis had to take stands on the various bills crossing his desk during the recall campaign. He signed a bill allow drivers' licenses for illegal immigrants although he had vetoed a similar bill in the past. Opponents charged that the governor was desperately seeking Latino votes. (And the legislature quickly repealed the license law after Schwarzenegger took office.)

Davis signed a hastily-drafted employer-mandated health insurance plan (which voters subsequently repealed in a 2004 referendum). Republicans charged that the Davis administration was signing off on state union contracts without obtaining sufficient pay concessions. Meanwhile, a court decision blocked sale of a pension bond without a vote of the people. And Davis' rollover bond mechanism was challenged in court—as expected—by the Pacific Legal Foundation on constitutional grounds.

Anything that suggested the budget was not yet under control was unfavorable for Davis. Moreover, the unpopular car tax hike went into effect October 1, only a few days before the October 7 recall election. After the recall succeeded and Schwarzenegger took office, the first official action he took was repealing the car tax hike. Although as governor he periodically defended that action, it immediately worsened the budget situation he inherited. And the car tax repeal continued to be an issue into the next budget crisis of 2008-09, when the car tax was again raised. But on the night he won office in the recall, Governor-elect Schwarzenegger promised the voters that "I will not fail you, I will not disappoint you, and I will not let you down."[78]

FAST FORWARD: THE BUDGET CRISIS OF 2008-09 AND BEYOND

"Our elected officials in Sacramento are facing a budget crisis unseen in this state since the Great Depression, and it was entirely avoidable... California's future is in danger."

—Candidate Arnold Schwarzenegger during the 2003 recall campaign[79]

"It's abundantly clear that just because you change governors you don't change the financial condition of the state."

—Former Governor Gray Davis commenting on the 2009 budget crisis[80]

On taking office, Arnold Schwarzenegger was in many respects the complete opposite of Gray Davis. He was ebullient, optimistic, and—of course — a celebrity, not someone initially elected, as Davis was, with a reputation as a competent, professional public administrator. But Schwarzenegger could be unfocused with too many goals, albeit popular goals.

Davis came into office focused on education. He retained that emphasis as long as the budget was flush. However, Davis' tendency to micromanage produced a variant of lack of focus—since it is impossible to handle everything once difficulties are encountered. Thus, early warning symptoms of the electricity crisis were missed. And the evolving budget crisis of the early 2000s eventually overwhelmed everything else, despite early denials by the governor's finance director that anything was amiss.

A RENEWED BUDGET CRISIS

The budget crisis of the early 2000s was clearly the major factor in the recall of Davis and Schwarzenegger's election as his replacement in 2003. Initially, because he inherited that crisis, Schwarzenegger *did* focus on fiscal affairs, putting the Davis borrowing plan into effect but doing so through clearly legal means. Schwarzenegger used his initial popularity to win voter approval of the needed (one-time) constitutional changes in 2004 under Propositions 57 and 58 to permit the borrowing. But the new governor took to feuding with the legislature the following year, putting a series of initiatives before the voters in 2005 as part of his "Year of Reform." Only one of these propositions was directly linked to the budget. And all failed at the ballot box while the governor's popularity plummeted.[81]

Part of the problem in 2005 was that during Schwarzenegger's campaign for the two 2004 borrowing propositions, he oversold what they could accomplish to the public. Voters were assured that the two measures would solve the state's fiscal problem and that afterwards the state would be able to "throw away the credit card." Instead, the state lived off the reserve that resulted from 2004 borrowings, aided by the improved economy, until 2007.

After the stinging rebuff he suffered the Year of Reform campaign of 2005, and with the 2006 gubernatorial election coming up, Schwarzenegger switched to promotion of the construction state infrastructure—to be financed by more borrowing. A seemingly no-cost expansion of infrastructure appealed to the electorate and the governor was re-elected by a strong margin. In 2007, the gubernatorial theme became adoption of a state universal health care program, promoted as self-supporting, but in fact with some budget risks.[82] However, Schwarzenegger's attention in 2007 was also on environmental issues, hydrogen highways, and greenhouse gases. That agenda won him international acclaim and even an invitation to address the United Nations. But neither the state budget nor proposals for state health care could be passed at the UN.

In the end, the health plan failed—in part due to wandering gubernatorial attention. There was only a narrow window of opportunity to pass a potentially-costly health plan before renewed budget pressures became apparent. And the window had closed by the time a full plan was readied for legislative action in late 2007. The plan was passed in the Assembly but rebuffed in the Senate as too risky to enact in the face of a deteriorating fiscal situation.

By 2008, a renewed California state budget crisis was well underway.[83] Continued fiscal deterioration led to a budget stalemate— and no budget—during the summer of 2008. During that summer, Governor Schwarzenegger dropped his opposition to a tax increase and advocated one. Ultimately, the stalemate lasted two and a half months, exceeding even the two-month record delay set under Davis. Moreover, the new budget, enacted in mid-September 2008 without the governor's proposed tax increase, quickly unraveled. GOP opposition to Schwarzenegger's tax prescription blocked the tax proposal he initially made.

A midyear revision of the 2008-09 budget was enacted in February 2009, this time raising taxes as well as cutting expenditures. The February deal also included an early budget for 2009-10. However, the enacted budget was partly dependent on a series of budget propositions that voters largely rejected in May 2009. That rejection and continued economic deterioration led to new negotiations for a revised budget for 2009-10.

California began the new fiscal year (2009-10) with the old February budget still in place. In contrast to prior years, when there was no budget on July 1, the state was authorized to spend. But it lacked the cash to pay

for all the authorized programs. By early July, the state controller began issuing registered warrants (IOUs) instead of cash for some payments. A budget revision deal reached in late July ostensibly fixed the renewed fiscal problem. It involved real cuts but much *de facto* and overt borrowing, questionable expected sales of state assets, and dubious savings and forecasts. One Democratic advisor rationalized the outcome on the grounds that it was necessary to "distinguish between the best possible solution and the best solution possible."[84] But the fear was that there had been no fundamental solution.

In particular, the new deal seemed unlikely to produce a positive or even zero reserve, given further economic decline. Litigation was threatened by local governments as the state dipped into their treasuries. Not all elements of the ostensible solution passed. The prison budget was to be cut in the face of legally-questionable inmate overcrowding but the specifics of how a reduced prisoner population was to be accomplished was left to be determined. In effect, the legislature dared a federal court to make the reductions. Although the Obama administration was trying studiously to avert its gaze from California's fiscal drama, the possibility (or hope) remained that there would eventually be federal assistance of some type.

SIMILAR RESULTS

We started with the obvious question of whether leadership matters in California. As outlined below, Gray Davis and Arnold Schwarzenegger had very different types of personalities, backgrounds, and leadership styles. Yet the Schwarzenegger budget crisis of 2008-09 seemed similar to the Davis crisis of the early 2000s. Voters had apparently thought that by recalling Davis and replacing him with Schwarzenegger, they would resolve the state's budget woes. The man on the white horse would ride in and defeat the bad guys in Sacramento, whoever they were. Despite this expectation, by 2009, the nation was treated to pundits pointing to California as ungovernable. Metaphors of sinking ships and cars running off cliffs were common as were references to failed states and third-world countries.

The fact that different governors ended with similar results suggests a structural interpretation. But typically, the structures to which reference is made are institutional in a political sense. The usual suspects are Proposition 13, the two-thirds vote requirements for new taxes and budget enactment, term limits, voter mandated spending and spending formulas, gerrymandered legislative districts, and polarized political parties. And so the remedies suggested generally revolve around political solutions such as new corrective initiatives or even a constitutional convention.

AN UNDERLYING REALITY

Despite the tendency to focus on them, political institutions are not created exogenously. There may well be a more fundamental economic reality beneath those institutions. Going back to gold rush days, California generally grew faster than the rest of the U.S. But California became an elderly state in the late 19th and early 20th centuries, along the lines of Florida today. People came from the cold Midwest to retire in the sunshine, or at least to live out their days in a warm climate. With many folks thinking about the hereafter, the state produced religious innovations, quack remedies, and invented the commercial cemetery. It also produced wacky "pensionite" movements that cemented the state's image as a place where oddities were the norm.

But at the same time, the nice weather had attracted movie making and airplane manufacture in the south in the early twentieth century. And in the Bay Area,

two guys named Hewlett and Packard were tinkering with electronic equipment in a garage in the late 1930s. With the impetus of World War II, which brought a veritable population explosion to the California to work in military production, California became a youth culture. After the War, returning GIs came back to stay. And after a pause, military needs of the Cold War, augmented by the hot Korean and Vietnam Wars, kept federal money flowing to the state's aerospace industry.

California continued to experience rapid growth compared with the U.S. as a whole. Land and housing was cheap. Suburbs could be built on low-cost farm land. The growth provided tax revenues to expand freeways and water projects, to fund a highly regarded K-12 educational system, and to create new public colleges and universities. By the mid-1960s, California became the largest state in the nation.

Growth comes at a cost, however, particularly in the face of heightened environmental sensitivities. Concerns arose about air and water pollution, congestion, and the quality of life for those already in California. Whereas Governor Pat Brown in the 1960s is remembered for infrastructure expansion, his son Jerry Brown was elected governor in 1974 touting "an era of limits." As population growth pressed against land and housing supply, property values rose. So did property tax assessments and bills, leading to Prop 13. Various "slow growth" movements followed, limiting new development. A major water project was rejected by voters in the early 1980s.

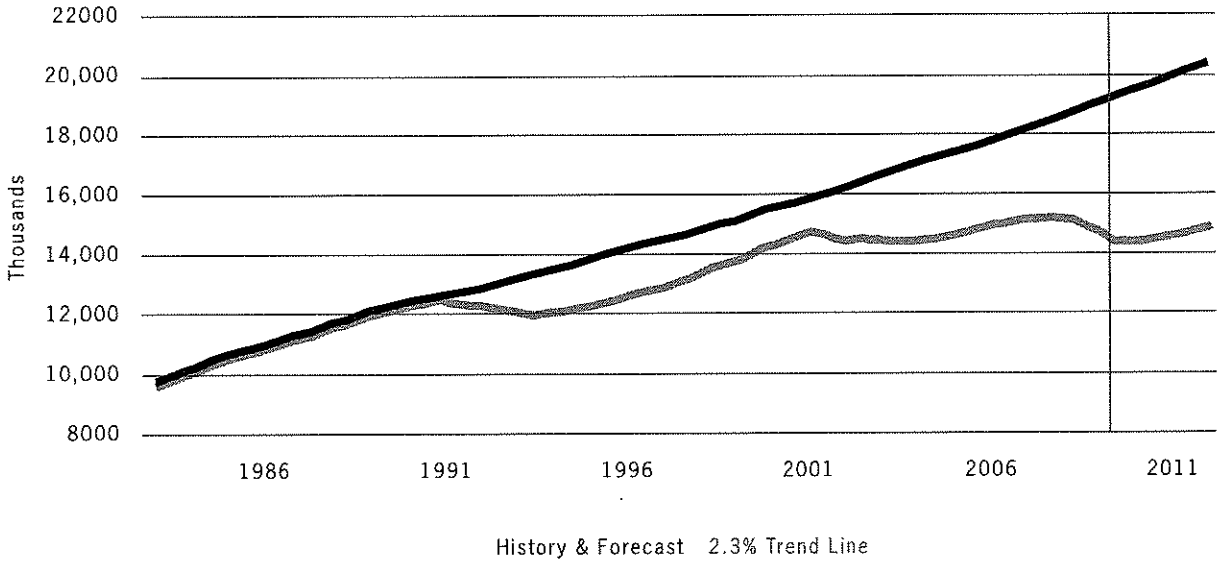
California experienced a budget crisis in the early 1980s. However, that period was also the era of President Reagan's "evil empire" which gave a new fillip to aerospace activity and temporarily masked the underlying shift. The budget crisis was eventually resolved under Governor George Deukmejian when growth resumed.[85] But by the end of the 1980s, the Soviet Union was dissolving and aerospace in California was substantially downsized, removing a base of high-wage jobs from the state. Immigration —reflecting developments in Mexico and others parts of the world—brought in new job-seekers, but biased toward the low-wage end of the scale.

A new downturn and budget crisis was left by Deukmejian to his successor, Governor Pete Wilson, first elected in 1990. Wilson wrestled with a budget crisis for much of his initial term.[86] And he often focused on illegal immigration as fiscal burden for the state. Much of his successful re-election campaign in 1994 centered on the immigration issue and on Prop 187, an initiative aimed at barring use of public services by illegal immigrants.

As Chart 3 shows, California never really recovered from the recession of the early 1990s. The problem that had developed by the late 1970s finally became apparent once the growth accompanying the end-stage of Cold War military spending was removed. Relative to the old trend, job growth in the state lagged, even during recovery and even during the dot-com boom and the later housing boom. California, in short, has been enmeshed in a decades-long process of converting from a state characterized by supernormal growth to a more average state.

Voter expectations about public services have lagged in recognizing this underlying shift. In the context of direct democracy, the result is a string of uncoordinated actions by initiative which mandate spending and weaken the legislature. While voters tend to see the governor as a kind of CEO who can fix the resulting fiscal strains, a weakened legislature inherently weakens the governor. Ultimately, it is the legislature that has to act on budgets and other state programs.

Chart 3: California Nonfarm Employment History & Forecast Vs. 2.3 % Trend from 1990:3



Source: UCLA Anderson Forecast (June 2009).

A ROLE FOR LEADERSHIP

Some governors have pointed to underlying causes but not the whole picture. As noted, Jerry Brown's "era of limits" suggested the rising cost of growth and a structural shift. But when it came to the major political consequence of the shift, Prop 13, Brown was either distracted or bemused and—in the end— flip-flopped from opposition to the proposition before it passed to support afterwards.[87] Deukmejian took the taxpayer revolt as a given and the last gasp of the Cold War helped pull the California economy back on track. In any case, he had little incentive to look for an underlying shift that was being temporarily obscured.

Wilson looked at the demographic element as an underlying cause of California's budgetary problems and ultimately did navigate the state out of the budget crisis of the early 1990s. But his preferred remedy, in effect state control of immigration via Prop 187, was doomed to fail since immigration control is the province of the federal government. Subsequent litigation largely voided Prop 187.

Finally, neither Gray Davis nor Arnold Schwarzenegger focused on underlying trends. Davis came into office during the dot-com boom when, despite the employment lag shown on Chart 3, the budget position of the state was temporarily strong. Ultimately, Davis viewed his fate as a function of the short-term business cycle. "Nobody seems to understand that the economy is like the tide," he complained. "When you're in high tide no one thinks low tide is coming."[88]

Schwarzenegger tended to point to the political symptoms of the underlying shift. His suggested political reforms, such as a larger rainy-day fund, would help at the margin. But his communications skills were never pointed toward acquainting the public with the difficulties the underlying economic shift entailed and the implications for public policy. Probably, his natural tendency toward optimism made it difficult to contemplate the idea that California had become a normal state in terms of its growth potential.

The Bad News is that California's virtuous circle of growth leading to revenue to supply the infrastructure for more growth began coming to an end in the 1970s. The state's size help obscure that reality. California politicians often point to the fact that if the state were a country, it would be the 6th or 7th largest in the world. But apart from electoral votes, size doesn't matter.

The Good News is that being average is not a terrible fate—if only California could find a leader to make the challenges of the transition explicit. Perhaps voters now realize that expecting a man (or a woman) on a white horse to fix the state's fiscal problem is unrealistic. The question is whether whoever emerges from the 2010 gubernatorial election will be willing to acquaint voters with the idea of California as a normal state.

1 Available at http://www.law.columbia.edu/graduation-2009/18213/2009-keynote-address.

2 Quoted in Dan Smith. "For Davis, dream comes alive today." *Sacramento Bee*, January 4, 1999.

3 The narrative in the material that follows is taken mainly from press information, mainly the *Sacramento Bee*. Footnote references are confined mainly to direct quotes.

4 Quoted in Dan Smith. "Friction grows between Davis, Democratic lawmakers." *Sacramento Bee*, July 22, 1999.

5 Available at http://www.californiagovernors.ca.gov/h/documents/inaugural_37.html.

6 James Glassman and Kevin A. Hassett. 1999. *DOW 36,000: The new strategy for profiting from the coming rise in the stock market*. New York: Times Business.

7 Davis inherited a lawsuit challenging the almost-complete voiding of Prop 187 by a court. Bustamante wanted Davis to drop Wilson's appeal. Davis followed a strategy of agreeing to "mediation" of the dispute – which essentially would result in the state agreeing to accept the court decision.

8 Michael Bustamante quoted in Dan Smith. "Davis underlings squirm under his iron-grip leadership." *Sacramento Bee*, February 21, 1999.

9 Quoted in Dan Smith. "On the job nearly 100 days, Davis quieting critics." *Sacramento Bee*, April 11, 1999.

10 Hilary McLean quoted in Stephen Green. "Key jobs in state remain unfilled – critics." *Sacramento Bee*, October 31, 1999.

11 Quoted in Steven A. Capps. "No frills first budget from Davis." *Sacramento Bee*, January 9, 1999.

12 PBS *NewsHour*. February 11, 1999. Transcript available at http://www.pbs.org/newshour/bb/education/jan-june99/CA_2-11.html.

13 Quoted in Steven A. Capps. "No frills first budget from Davis." *Sacramento Bee*, January 9, 1999.

14 Quoted in John Jacobs. "Gray Davis' first budget: Distinctly status quo." *Sacramento Bee*, January 12, 1999.

15 Quoted in Steven A. Capps. "Davis tells how he would use surplus." *Sacramento Bee*, May 15, 2009.

16 Quoted in Dennis Love. "Initiative backers hope to drive car tax into ground." *Sacramento Bee*, May 21, 1999.

17 Quoted in Steven A. Capps. "Davis reneged on budget deal, GOP says." *Sacramento Bee*, July 2, 1999.

18 Quoted in Dan Smith. "Friction grows between Davis, Democratic lawmakers." *Sacramento Bee*, July 22, 1999.

19 Quoted in Steven A. Capps. "Davis offers 'prudent' $88 billion budget." *Sacramento Bee*, January 11, 2000. Note: The $88 billion figure in the headline refers to the entire budget, not just the general fund.

20 Garry South quoted in Amy Chance. "Back education plans with funds, critics urge." *Sacramento Bee*, January 6, 2000.

21 Quoted in Steven A. Capps. "State budget picture gets even rosier – Projection for surplus up $3 billion." *Sacramento Bee*, January 14, 2000. Brulte succeeded minority leader Ross Johnson who stepped down unexpectedly in late April 2000.

22 Eastin reportedly had favored a Davis rival in the 1998 gubernatorial primary. Dan Walters. "Davis doghouse gets crowded." *Sacramento Bee*, January 27, 2000.

ENDNOTES

23 An earlier ballot measure in March 2000 sought to reduce the hurdle to a simple majority but it failed.

24 Sandy Harrison quoted in Steven A. Capps, "State expects budget surplus – Revenues increase for fifth year in a row." *Sacramento Bee*, November 16, 2000.

25 Phil Troustine quoted in Steven A. Capp, "Senator seeks $2 billion to stabilize power rates." *Sacramento Bee*, November 21, 2000.

26 See Steven A. Capp, "Senator seeks $2 billion to stabilize power rates." *Sacramento Bee*, November 21, 2000.

27 Roger Peters quoted in Carrie Peyton. "PUC weighs power hikes – Hearing starts with utility pleas." *Sacramento Bee*, December 28, 2000.

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